

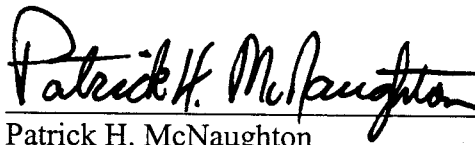
REPORT OF EXAMINATION
COMMENCEMENT BAY LIFE INSURANCE COMPANY
SEATTLE, WASHINGTON
DECEMBER 31, 2002



Participating State:
Washington

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify that I have reviewed the attached Report of Examination of the financial condition and affairs of **Commencement Bay Life Insurance Company** of Seattle, Washington as of December 31, 2002.

A handwritten signature in black ink, reading "Patrick H. McNaughton", written over a horizontal line.

Patrick H. McNaughton
Chief Examiner

9-18-03

Date

COMMENCEMENT BAY LIFE INSURANCE COMPANY

TABLE OF CONTENTS

	<u>Page</u>
Salutation	5
Scope of Examination	5
Instructions.....	6
Comments and Recommendations.....	8
History.....	9
Management and Control:	
Shareholders	9
Board of Directors	9
Officers	9
Affiliated Companies	11
Corporate Records:	
Conflict of Interest.....	11
Contracts	11
Minutes	11
Internal Security:	
Fidelity Bonds	12
Other Insurance	12
Internal Controls	12
Officers & Employees Welfare and Pension Plans	12
Territory and Plan of Operations	12
Growth of the Company	13
Business in Force By State.....	13

**COMMENCEMENT BAY LIFE
INSURANCE COMPANY**

TABLE OF CONTENTS

	<u>Page</u>
Reinsurance	13
Accounting Records and System:	
General Accounting	14
Actuarial Opinion	14
Subsequent Events	14
Financial Statements:	
Balance Sheet	15
Statement of Operations	16
Schedule of Change in Surplus	17
Notes to Financial Statements	18
Acknowledgment	20
Affidavit	21

SALUTATION

Seattle, Washington
September 18, 2003

The Honorable Mike Kreidler
Insurance Commissioner
State of Washington
PO Box 40255
Olympia, WA 98504

Dear Commissioner Kreidler:

In accordance with your instructions and in compliance with the statutory requirements of RCW 48.03.010, an examination has been made of the corporate affairs and financial records of:

**COMMENCEMENT BAY LIFE
INSURANCE COMPANY**
of
Seattle, Washington

hereinafter referred to as "CBL" or the "Company", at its home office located at 1800 9th Avenue Seattle, Washington 98111.

This report of examination is respectfully submitted, showing the condition of the Company as of December 31, 2002.

SCOPE OF EXAMINATION

The examination covered a seven-year and three month period from October 1, 1995 to December 31, 2002. The examination was conducted in accordance with the statutory requirements contained in the Revised Code of Washington and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook. The examination included identification and disposition of material transactions and events occurring subsequent to December 31, 2002 that were noted during the examination.

INSTRUCTIONS

1. Investment Transactions

After 1998, investment transactions were not approved by the Board of Directors. The investment transactions were approved by the investment committee of The Regence Group, CBL's holding company, but were never presented to the Board of CBL for approval. Under RCW 48.13.340, investments or loans require timely authorization or approval by CBL's Board, or an appropriate committee. If authorized by a committee, its minutes must be submitted to the Board for approval.

The Company is not in compliance with the provisions of RCW 48.13.340; it is instructed to revise its procedures so that all future investment transactions are approved in a timely fashion by the CBL Board of Directors at the next regular meeting following the transaction.

2. Record of Investments

The Company does not maintain an authorized written record in permanent form showing the authorization of investments. Under RCW 48.13.350, "... as to each investment of a domestic insurer a written record in permanent form showing the authorization thereof shall be made and signed by an officer of the insurer or the chairman of such committee authorizing the investment".

The Company is not in compliance with RCW 48.13.350 and is instructed to revise its procedures and maintain a written record of all investment transactions approved by the appropriate officer or the chairman of the investment committee.

3. Intercompany Cost Allocation Agreement

The Company does not have a current written service agreement to cover cost allocations of overhead expenses such as legal, investment management, and other administrative costs. The Company is using a service agreement between Commencement Bay and Pierce County Medical (now Regence BlueShield) dated April 15, 1993. Pursuant to RCW 48.31B.030(1)(a)(i) and (ii), services performed by Regence Blue Shield are required to be "fair and reasonable" as to terms and charges. In addition, RCW 48.31B.030(1)(a)(iii), requires that expenses incurred and payment received must be allocated to the insurer in conformity with customary insurance accounting practices consistently applied. Finally, RCW 48.31B.030 (1)(a)(iv) stipulates that: "The books, accounts, and records of each party to all such transactions must be so maintained as to clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties."

The Company's activities have significantly changed since inception of the 1993 agreement, rendering the agreement inequitable for the current operating environment. The 1993 agreement provides for compensation based upon a percentage of premiums written. However, there were no policies in effect after June 2001 and many administrative activities continued with no compensation base to support them. Pursuant to RCW 48.31B.030(1)(b)(iv), the Company is instructed to submit for approval to the Washington State Insurance Commissioner's Office a current cost allocation service agreement with Regence BlueShield which complies with RCW 48.31B.030(1)(a)(i),(ii) and (iii) and which recognizes an equitable cost sharing formula for distributing costs in all operating scenarios.

4. Actuarial Issues

The Company utilizes both consulting and in-house actuaries to sign its Statement of Actuarial Opinion. According to WAC 284-07-380(2)(a)(ii), these consulting actuaries must be approved by the Board of Directors. However, the consulting actuaries utilized during the exam period were not approved by the Board.

Pursuant to WAC 284-05-040, "No report, statement or document shall be filed with the insurance commissioner or issued to the public in relation to the business of insurance if it is signed by an actuary unless the person signing as an actuary is a qualified actuary." Per WAC 284-05-060, a qualified actuary is defined as "a member of the American Academy of Actuaries" or someone who "has otherwise demonstrated his or her actuarial competence to the satisfaction of the insurance commissioner." The in-house actuaries utilized by the Company during the exam period did not possess these qualifications and were not alternatively approved by the OIC.

Pursuant to WAC 284-07-380(2)(a)(ii), the Company is directed to have all consulting actuaries approved by the Board of Directors. Further, the Company must ensure that in-house actuaries meet the qualifications specified in WAC 284-05-060.

5. Board of Directors

Per the Company By-Laws, "The Board of Directors shall consist of at least five individuals". In 2000, there were three members of the Board of Directors. In 2001, the Company did reinstitute the five member Board. Pursuant to RCW 48.06.200(2), the directors shall be not less than five in number if a stock insurer.

In 2000, the Company was not in compliance with RCW 48.06.200(2) and is instructed to have five board members at all times in the future who are United States citizens, of which two-thirds are residents of Washington State.

COMMENTS AND RECOMMENDATIONS

1. Investment Controls

Currently, Bank of America is notified by telephone of all short term investment decisions by the investment manager of Regence BlueShield. No written documentation is prepared by the Company to support these transactions. Instead the documentation consists of a bank-prepared trade ticket, which is faxed to the Company. Unlimited authorization to conduct purchases and sales of securities has been delegated by the board of directors to the President and CFO of Regence BlueShield. The Investment Manager of Commencement Bay also has limited authority as allowed by the investment policy. All actual processing is done by the Investment Manager and Senior Accountant. Checks are not performed by the Company on the clerical accuracy of investment computations performed by the PAM system used by Mellon Bank, which the Company reconciles to their general ledger. Discretionary authority for investments held at Mellon Bank has been given to US Bancorp, guided by the Company's Investment Policy. The Company believes that their subsequent review of transactions gives them adequate control over investment decisions.

Maintaining written documentation for all accounting transactions is a prudent business practice. This should entail preparing documentation when transactions are initiated which would permit verification when paperwork is received from the bank and would allow the Company to detect possible errors. Authorization of investment transactions is best limited to persons having a direct relationship with, and knowledge of, such transactions. Since few persons are involved in the day-to-day transaction processing, the Company has a limited amount of control over such transactions. The Company also loses control over its investment decisions by delegating authority for purchases and sales to an outside source, even though the source uses the Company's investment policy for direction. In light of the aforementioned weaknesses, the Company should reevaluate its investment processes to incorporate sufficient internal controls. This can be accomplished by enhancing documentation, expanding the approval process, performing sample checks of investment computations accuracy and restricting internal and external authorization powers.

2. Custodial Agreements

In the 2002 Annual Statement Interrogatory #22.01, the Company states that it is not in compliance with the NAIC Financial Condition Examiner's Handbook (FCEH) in regard to the custodial agreements it has with Mellon Bank and Bank of America.

The Company maintains that it need not comply with the FCEH requirements since Washington State has not adopted the applicable NAIC Model law provision. However, since the requirements are designed to protect the Company, it recommended the custodial

agreements be revised to comply with the NAIC Financial Condition Examiners Handbook and ensure that the agreements include the following:

- a. State that certificated securities of the insurer shall be held separate from all other securities or in fungible bulk.
- b. State that all securities held in fungible bulk shall be separately identified on the custodian's books as being owned by the insurer.
- c. State that registered custodial securities shall be registered in the name of the company or its nominee, the custodian or its nominee, or a clearing corporation or its nominee.
- d. Include a provision that requires that the assets of the account are withdrawable upon demand.
- e. Require that all transfers be confirmed.
- f. Require a written agreement requiring that if the custodian gains entry in to a clearing corporation through an agent, the agent should be subject to the same liability for loss of the securities as the custodian.
- g. Require the custodian accept responsibility for the negligence of persons it may appoint to meet its obligations under the agreement.
- h. Require the custodian to notify the commissioner within 3 days if a custodial account is terminated or 100% of the account assets are withdrawn.
- i. Require the custodian to forward to the Company internal control reports from The Clearing Corporation, The Federal Reserve or its outside auditors.
- j. Require the custodian to secure and maintain insurance protection for custodial assets.
- k. State that registered custodial securities shall be registered in the name of the company or its nominee, the custodian or its nominee, or the clearing corporation or its nominee.

HISTORY

Commencement Bay Life Insurance Company (CBL) was incorporated on September 1, 1992 as a Washington stock life and disability insurance company. It was a wholly-owned subsidiary of Pierce County Medical Bureau, Inc. (PCMB). As a result of the merger on April 1, 1997 between Pierce County Medical and Regence BlueShield, the Company became a wholly-owned subsidiary of Regence BlueShield. Since inception, the primary business activity of CBL has been to provide stop loss insurance for administrative service contracts.

MANAGEMENT AND CONTROL

Shareholders

The Company is a wholly-owned subsidiary of Regence BlueShield a Washington non-stock, not-for-profit, health care service contractor.

Board of Directors:

The Bylaws of the corporation vest control of the Company in a Board of Directors consisting of five (5) members. The Bylaws also provide that each director shall be elected at the annual meeting of shareholders held on the second Tuesday of July. During 2000, the Company only had three board members. The following individuals served the Company as Directors and Officers as of December 31, 2002.

Directors:**Director****Business Affiliation**

Robert Scott Kuecker

President & Chief Actuary
Commencement Bay Life
Vice President & Chief Actuary
Regence BlueShield

Mary Oliver McWilliams

President
Regence BlueShield

Jo Anne Cynthia Long

Senior Vice President & General
Counsel
Regence BlueShield

Eric M. Tanaka

Vice President
Regence BlueShield

Margaret Taylor Stanley

Senior Vice President
Regence BlueShield

Officers:**Name****Position Held**

Robert S. Kuecker

Chairman & President

Jo Anne Cynthia Long

Secretary

Eric M. Tanaka

Treasurer

Robert S. Kuecker

Actuary

Affiliated Companies

The Company is a wholly-owned subsidiary of Regence BlueShield (RB), which is a wholly-controlled affiliate of The Regence Group (TRG), a non-profit, non-insurer holding company. Regence BlueShield is a non-profit, taxable Health Care Service Contractor (HCSC) and is one of four 100% wholly-controlled affiliates (three HCSC's and one mutual insurer), of TRG. The four direct TRG subsidiaries in turn own 33 other companies in related fields, bringing the total number of companies in the group to 38, including TRG.

CORPORATE RECORDS

Conflicts of Interest

A resolution of the Board of Directors provides that every officer, director, committee member or responsible employee disclose to the Board of Directors any material interest or affiliation which conflicts with the duties of such person on behalf of the Company. A review of the individual conflict of interest statements on file with the Company as of May 15, 2002 revealed no material exceptions. Potential conflicts were duly disclosed to the Board in accordance with the Company's conflict of interest policy.

Contracts

As of December 31, 2002, the Company was a party to the following contracts:

1. An Insurance Service Agreement with the parent, Regence BlueShield (RB), effective April 15, 1993. The agreement provides for CBL to pay RB a fee at a rate not to exceed 15% of gross written premium for the services provided by the parent.
2. A Tax Allocation Agreement between The Regence Group and affiliates dated September 20, 2000. The agreement stipulates that the tax liability of each member shall not exceed the tax liability such member would have paid if it had filed on a separate return basis.
3. A Stop Loss Insurance Services Agreement with Regence BlueShield, a health care service contractor in Seattle, Washington, effective December 1, 1994. The agreement provides for CBL to provide stop loss insurance policies for self-funded groups administered by Regence BlueShield.

Minutes

All minutes of meetings of the Board of Directors were reviewed for the period under examination. There have been numerous changes to the Board of Directors and Officers of the Company since the inception of the corporation. At December 31, 2000, there were three members of the Board of Directors even though the By-Laws stipulate that there should be five. Board meetings were held in accordance with the provisions of the Corporation By-Laws.

INTERNAL SECURITY

Fidelity Bonds

Officers and employees of Commencement Bay Life Insurance Company are covered under the fidelity bond coverage of the holding company, The Regence Group. According to the parent company's file, the coverage meets the minimum amount suggested by the National Association of Insurance Commissioners (NAIC).

Other Insurance

The Company is a named insured on commercial and umbrella liability, professional liability, and directors and officer's liability policies issued to the holding company, The Regence Group.

Internal Controls

Internal controls on cash receipts, cash disbursements and EDP Systems were evaluated and no material weaknesses were found.

OFFICERS AND EMPLOYEES WELFARE & PENSION PLANS

Officers of CBL are also employees of Regence BlueShield, the parent company, and thus are covered under The Regence BlueShield plan.

TERRITORY AND PLAN OF OPERATIONS

The Company is authorized to operate in the state of Washington as a life and disability insurance company. The primary purpose of CBL was to provide stop loss insurance on Administrative Services Contracts (ASC) administered by Regence BlueShield. Active marketing of CBL stop loss insurance was phased out beginning in 2000. Groups purchasing CBL stop loss insurance were encouraged (but not required) to migrate to similar stop loss coverage provided by Regence Life & Health of Oregon. The CBL 2003 business plan anticipates that the company will begin to reinsure selected contracts written by Regence BlueShield of Idaho.

GROWTH OF THE COMPANY

The growth of the Company is reflected in the following schedules:

Schedule 1 (000s) omitted

<u>Year</u>	<u>Assets</u>	<u>Liabilities</u>	<u>Capital & Surplus</u>
1995	\$ 7,434	\$1,415	\$6,019
1996	8,311	1,973	6,339
1997	9,767	2,512	7,255
1998	11,115	3,002	8,113
1999	12,299	3,795	8,503
2000	11,695	1,996	9,699
2001	10,304	210	10,094
2002	10,541	243	10,298

Schedule 2 (000s) omitted

<u>Year</u>	<u>Net Premium Written</u>	<u>Net Investment Income</u>	<u>Net Income</u>
1995	\$1,839	\$369	\$ 737
1996	1,613	382	317
1997	1,718	468	914
1998	1,876	526	886
1999	2,055	573	260
2000	2,080	566	1,192
2001	97	537	372
2002	0	278	246

BUSINESS IN FORCE BY STATE

The Company is only licensed to do business in Washington. In 2002, the Company did not have any premiums.

REINSURANCE

The Company had no reinsurance transactions during the period under examination.

ACCOUNTING RECORDS AND SYSTEMS

General Accounting

Daily accounting activities of the Company are performed by Regence BlueShield using the mainframe system IVIS and Excel spreadsheets. The financial records are maintained on a GAAP (Generally Accepted Accounting Principles) basis with SAP (Statutory Accounting Principles) adjustments made using Excel spreadsheets. All investment accounting is done through the Princeton Asset Management (PAM) system at Mellon Bank and reviewed by employees of The Regence Group.

ACTUARIAL OPINION

The Company is exempt pursuant to WAC 284-07-310 through 284-07-400 from submitting a statement of actuarial opinion based on an asset adequacy analysis. The statement of actuarial opinion provided by CBL's Appointed Actuary is not based on an asset adequacy analysis and is in accordance with WAC 284-07-370.

SUBSEQUENT EVENTS

The Commencement Bay Life Insurance Company's 2003 business plan anticipates that the Company will begin to reinsure selected contracts written by Regence BlueShield of Idaho.

FINANCIAL STATEMENTS

December 31, 2002

The following financial statements report the financial condition of the Company, for which there were no examination adjustments:

- Balance Sheet
- Statement of Operations
- Schedule of Changes in Surplus
- Notes to Financial Statements

Commencement Bay Life Insurance Company
Balance Sheet
December 31, 2002

	<u>BALANCE</u> <u>PER COMPANY</u>	<u>BALANCE</u> <u>PER EXAM</u>
ASSETS		
Bonds (A)	\$1,280,014	\$1,280,014
Common Stocks	0	0
Cash on Hand and On Deposit (B)	8,788,797	8,788,797
Short Term Investments (C)	452,425	452,425
Investment Income Due & Accrued (D)	<u>19,884</u>	<u>19,884</u>
TOTAL ASSETS	<u>\$10,541,119</u>	<u>\$10,541,119</u>
LIABILITIES		
Policy & Contract Claims-A&H	\$0	\$0
Federal and foreign income taxes (E)	104,399	104,399
Taxes, Lic & Fees Due & Accrued	0	0
Asset Valuation Reserve (F)	162	162
Payable to Parent, Subs & Affiliates (G)	<u>138,601</u>	<u>138,601</u>
TOTAL LIABILITIES	<u>\$243,161</u>	<u>\$243,161</u>
CAPITAL AND SURPLUS		
Common Capital Stock (H)	\$2,400,000	\$2,400,000
Paid-in & Contributed Surplus (I)	2,600,000	2,600,000
Unassigned Funds (Surplus) (J)	<u>5,297,958</u>	<u>5,297,958</u>
TOTAL CAPITAL & SURPLUS	<u>\$7,897,958</u>	<u>\$7,897,958</u>
TOTAL LIABILITIES & NET WORTH	<u>\$10,541,119</u>	<u>\$10,541,119</u>

**Commencement Bay Life Insurance
Summary of Operations
Year Ended December 31, 2002**

	<u>BALANCE PER COMPANY</u>	<u>BALANCE PER EXAM</u>
Premiums & Ann. Considerations	\$0	\$0
Net Investment Income	<u>278,386</u>	<u>278,386</u>
Total Income	<u>278,386</u>	<u>278,386</u>
Benefits Under A&H Policies	0	0
Commissions on Premiums	0	0
General Insurance Expenses	0	0
Taxes, Licenses & Fees	<u>1,229</u>	<u>1,229</u>
Total Benefits & Expenses	<u>1,229</u>	<u>1,229</u>
Net Gain from Operations	<u>277,157</u>	<u>277,157</u>
Federal Income Taxes	<u>31,483</u>	<u>31,483</u>
NET INCOME	<u>\$245,673</u>	<u>\$245,673</u>
CAPITAL AND SURPLUS		
Capital & Surplus, previous year	\$10,094,251	\$10,094,251
Net Income	245,673	245,673
Change in Asset Valuation Reserve	970	970
Change in net deferred income tax	<u>(42,936)</u>	<u>(42,936)</u>
Capital & Surplus, Current year	<u>10,297,958</u>	<u>10,297,958</u>

COMMENCEMENT BAY LIFE INSURANCE COMPANY
SCHEDULE OF CHANGES IN SURPLUS
FOR 7 YEARS ENDING 12-31-2002

	12/31/1996	12/31/1997	12/31/1998	12/31/1999	12/31/2000	12/31/2001	12/31/2002
Capital and Surplus Dec 31 Previous Year	\$6,018,895	\$6,338,518	\$7,254,845	\$8,113,195	\$8,503,196	\$9,699,025	\$10,094,251
Net Income	316,527	913,913	885,665	259,653	1,192,223	372,435	245,673
Change in Asset Valuation Reserve	3,096	2,414	(27,315)	131,543	2,408	(579)	970
Change In Non-admitted Assets				(1,195)	1,195		
Change in Deferred Income Tax						8,971	(42,936)
Change effect of changes in Acct Principles						14,396	
Rounding					3	3	
Net Change in Capital and Surplus for Year	\$319,623	\$916,327	\$858,350	\$390,001	\$1,195,829	\$395,226	\$203,707
Capital and Surplus Dec 31 Current Year	\$6,338,518	\$7,254,845	\$8,113,195	\$8,503,196	\$9,699,025	\$10,094,251	\$10,297,958

**COMMENCEMENT BAY LIFE
INSURANCE COMPANY**

NOTES TO FINANCIAL STATEMENTS

A. Bonds \$1,280,014

Bonds were reported in the Annual Statement at amortized cost in accordance with NAIC valuation rules. The Company's investment in bonds represented 12.1% of its total admitted assets as of December 31, 2002. All bonds were owned by the Company and were valued in accordance with the procedures prescribed by the NAIC Valuations of Securities manual. These bonds were verified by direct confirmation with the custodial bank.

B. Cash on Hand & on Deposit \$8,788,797

Cash consisted of the following accounts as of December 31, 2002

<u>Description</u>	<u>Amount</u>
Bank of America - Cash	\$ 85,986
Bank of America – Short Term Securities	5,411,125
US Bancorp – Short Term Securities	<u>3,291,686</u>
	\$ 8,788,797

The individual balances were reconciled to the general ledger and were additionally verified through bank confirmations obtained directly from the bank.

C. Short Term Investments \$452,425

Investments with an original maturity of one year or less from the purchase date are classified as Short-Term Investments. Investments with an original maturity of 90 days or less are reported on the Annual Statement, Schedule E.

D. Investment Income Due & Accrued \$19,884

The balance represents interest income due and accrued on bonds as of December 31, 2002. The examination of the account was performed in conjunction with the examination of Bonds and was determined to be reasonably stated.

E. Federal and Foreign Income Taxes \$104,399

The balance represents amounts payable to the IRS for federal income taxes. The workpapers were reviewed and the balance appears to be reasonable.

F. Asset Valuation Reserve \$162

The Asset Valuation Reserve was calculated in accordance with the instructions provided by the Securities Valuation Office of the NAIC. The purpose of the reserve is to safeguard the Company's surplus from the effect of investments whose quality has deteriorated and from unrealized losses not eligible for amortization. The balance represents the adjusted Asset Valuation Reserve as of December 31, 2002.

G. Payable to Parent, Subsidiaries & Affiliates \$138,601

The balance represents direct expenses paid by the parent, Regence BlueShield. The balance is settled at least quarterly or more frequently depending upon the cash flow or capital requirements of the Company.

H. Common Capital Stock \$2,400,000

The reported amount represents the par value of 240,000 outstanding shares at \$10 a share as of December 31, 2002. This amount did not change during the period under examination. The amount satisfied the initial minimum capital requirements for a domestic life and disability insurer as set forth in RCW 48.05.340.

I. Paid-In & Contributed Surplus \$2,600,000

The balance represents the additional contribution paid by the only stockholder, RB, the parent company. The amount is more than the required additional surplus of \$2,400,000 set forth under RCW 48.05.340.

J. Unassigned Funds (Surplus) \$5,297,958

The above amount represents the adjusted balance of Surplus.

COMMENCEMENT BAY LIFE INSURANCE COMPANY

ACKNOWLEDGMENT

The cooperation and assistance of the officers and employees of the Company during the examination are hereby acknowledged.

In addition, Susan Campbell, CPA, FLMI, Examiner-in-Charge; Kathy Hicks, CPA; John Gaynard, CPA, AFE, FLMI; and John Jacobson, AFE, IS Specialist, Insurance Examiners, all from the Washington State Office of Insurance Commissioner, participated in the examination and preparation of this report.

AFFIDAVIT

